ASSESSMENT OF RETAIL AND WHOLESALE MARKET COMPETITION IN THE ILLINOIS ELECTRIC INDUSTRY IN 2001

ILLINOIS COMMERCE COMMISSION

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Executive Summary

Sec. 16-120(b) of the Public Utilities Act ("Act") directs the Illinois Commerce Commission ("Commission") to submit an annual report to the Joint Committee on Legislative Support Services of the General Assembly and the Governor that provides information concerning the development of competitive electricity markets in Illinois. This is the second report the Commission has submitted to the General Assembly pursuant to Sec. 16-120(b) of the Act.[1]

The Sec. 16-120(b) reports will continue to 2006. The series of reports will thus consider developments in the Illinois electric industry occurring during the "transition period," during which the State's electric utilities are expected to increase efficiency and reduce costs in preparation for the period, beginning as early as 2007, when they will no longer be permitted to charge transition charges to customers who choose alternative suppliers.

Sec. 16-120(b) requires the Commission to furnish certain statistical information concerning power and energy sales by electric utilities and also by Alternative Retail Electric Suppliers ("ARES") to customers eligible to select new suppliers. The Commission may also provide any other information the Commission believes is relevant in assessing the development of Illinois electricity markets. In this report, in addition to statistical information, the Commission examines the competitiveness of the retail and wholesale electric markets. In particular, the report discusses the effect that an uncompetitive wholesale market could have on consumer prices when the bundled rate freeze currently in effect expires in 2005.

Retail Market Activities

The electric market opened in October 1999 to approximately one-third of all non-residential customers, comprising a total of about 64,000 customers. On January 1, 2001, all non-residential customers of the investor-owned utilities became eligible for delivery services. The number of eligible non-residential customers (excluding street lighting customers) is now about 500,000.

Supply Options Available to Delivery Services Customers

Theoretically, customers eligible for delivery services have several supply options available from both the incumbent utilities and from alternative suppliers. Customers may purchase bundled power and energy offered by the incumbent utilities at rates regulated by the Commission. These rates are frozen until 2005. In addition, both prior to the 1997 restructuring law and subsequent to the enactment of the

[1] Section VI of the report contains a list of reports concerning electric competition that are available on the Commission's website at www.icc.state.il.us.

restructuring law, some utilities have offered discounted bundled rate contracts to customers.

Non-residential customers may also choose to purchase power and energy on an "unbundled" basis, by switching the generation portion of their electric service to an ARES or from any electric utility serving outside its traditional service area. (Collectively, the ARES and electric utilities serving outside their service areas are called "Retail Electric Suppliers" or "RESs"). Some utilities also offer an unbundled generation option called the "Power Purchase Option" ("PPO"). As described in Section 16-110 of the Act, non-residential customers subject to transition charges must be offered the "PPO". Currently, only four utilities (AmerenCIPS, AmerenUE, Commonwealth Edison and Illinois Power) charge transition charges to customers who receive delivery services. Unbundled power and energy, whether purchased from an ARES, or from an electric utility under the PPO, is delivered to customers under "delivery services tariffs" at rates regulated by the Commission.

The number of delivery services customers, including both customers purchasing power from a RES and customers taking PPO service, now totals about 20,000 (about double last year's total). From 2000 to 2001, ComEd experienced delivery services customer growth of about 92% during 2001, growth in the IP service area was about 33%, and growth in the AmerenCIPS area was only about 6%.

Retail Electric Supplier Activities

Eighteen RESs are now qualified to sell power and energy to retail customers, a total that is larger than the year 2000 total. The Commission certified five new ARES in 2001, while three suppliers requested decertification from the Commission. Eleven RESs made sales to retail customers during 2001. A few of the RESs made sales to a handful of customers only. With one exception, each of the currently active RESs (that is, RESs that have sold power and energy to customers) is either an electric utility or an affiliate of an Illinois electric and/or gas utility.

RES made sales in 2001 of about 12 million megawatt-hours. This total represents about 14% of the load eligible for delivery services. It appears that RES marketing activities were confined solely to the service areas of the State's three largest utilities, AmerenCIPS, Commonwealth Edison ("ComEd") and Illinois Power. With the possible exception of the MidAmerican service area, there was no indication by the end of 2001 that RESs were actively marketing in any of the State's smaller service areas.

Importance of the Power Purchase Option

In 2001, most of the unbundled power and energy sales were PPO sales. Over half of ComEd customers taking delivery services at the end of 2001 were PPO customers by the end of 2001. About 99% of customers with a load of less than one megawatt ("MW") taking delivery services from Illinois Power under one MW were

taking service under the PPO. Only in the AmerenCIPS service area did the ratio of PPO to non-PPO customers decrease significantly during 2001. This was most probably attributable to a reduction in transition charges to zero for most AmerenCIPS customers, which rendered those customers ineligible for the PPO. About 12% of AmerenCIPS' delivery services customers are now receiving PPO service, a large drop from last year's 80% figure.

As the Commission noted in last year's report, customer (and supplier) reliance on the PPO may be cause for concern for the long-term development of the market, primarily because of the temporary nature of the PPO. Utilities will cease offering the PPO by the end of 2006, the scheduled date at which utilities may no longer impose transition charges to delivery services customers. Another reason the growth in PPO sales may be of concern is that PPO sales grew even though wholesale electric prices dropped significantly in 2001 compared to 2000. Relatively low wholesale prices would seemingly encourage suppliers to purchase power and energy on the wholesale market rather than rely on the incumbent utility as a supply source.

Residential Market Opening in 2002

The residential market will open to choice on May 1, 2002 to approximately 4,250,000 customers. Based on the small number of informal inquiries from potential RESs about certification requirements, the Commission perceives at this time only a limited RES interest in the residential market. It is possible that significant activity in this market will not occur until the expiration of the rate freeze in 2005.

The RESs that intend to serve the residential market will likely focus their initial residential marketing efforts in the ComEd service area. The customers participating in the choice programs offered by natural gas utilities in the ComEd area will probably be the first group of customers solicited by RESs.

Peak Demand and Sales

The sum of the peak demands of the nine investor-owned utilities totaled approximately 29,465 megawatts in 2001. This total, which encompasses both unbundled and bundled customer demand, represents an increase in peak demand of approximately 5.1%, compared to 2000. During the period between 1991-2001, the annual growth rate in peak demand has been about 1.7%, an increase of about 320 megawatts per year.

Wholesale Market Activities

The ultimate success of electric restructuring depends to a great extent on the competitiveness of the wholesale market. The competitiveness of the wholesale market will also greatly influence the electricity prices for both unbundled and bundled customers. Since the State's largest utilities have transferred or sold their generating facilities, the power and energy needed to serve their retail customers must be

purchased from merchant generators in the wholesale market. Currently, these utilities have wholesale power contracts in place with the companies that now own the generating facilities, but these contracts will expire by January 1, 2005, just as the retail rate freeze expires.

While wholesale prices have dropped considerably over the past year, it is unknown how this price decrease will affect the prices utilities pay for power deliveries that begin in 2005. It may also be too early to predict whether the power prices retail customers will pay in 2005 and later years will be higher than the prices they are currently paying. However, the Commission is concerned that the wholesale market is not sufficiently competitive to ensure that wholesale prices remain at reasonable levels.

The main reason for the Commission's concern about a lack of wholesale market competitiveness derives from the recognition that, at present, there is only a limited amount of transmission capacity available to the generators located outside the largest utility service areas. An added factor is that the largest generation operator in each of the State's four largest service areas is an affiliate of the incumbent utility. Both of these reasons may result in the ability of the affiliated generators to drive wholesale prices above competitive levels. Such non-competitive prices will ultimately be reflected in prices paid by retail customers.

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I. Introduction

Sec. 16-120(b) of the Public Utilities Act requires the Illinois Commerce Commission to submit an annual report to the Joint Committee on Legislative Support Services of the General Assembly and the Governor describing the development of electric competition in Illinois. This is the Commission's second annual report submitted to the General Assembly under Sec. 16-120(b). The Commission has submitted previous reports to the General Assembly concerning the changes to the Illinois electric industry that have taken place since the December 1997 enactment of the Electric Customer Choice and Rate Relief Law of 1997. A list of these reports is presented in Section VI of this report.

Sec. 16-120(b) requires the Commission to furnish certain statistical information related to sales by electric utilities, both inside and outside their service territories, as well as sales by Alternative Retail Electric Suppliers ("ARES"). In addition, the Commission may provide "any other information the Commission considers significant in assessing the development of Illinois electricity markets…" In this report, the Commission examines the development of electric retail and wholesale markets (Sections III and IV of the report, respectively).

The trends in the rate of customer switching and other quantitative measures of retail activity that were apparent in 2000 largely continued into 2001. The Commission continues to find signs of retail electric market growth in the service territories of the three largest utilities in the state. In the Commonwealth Edison ("ComEd") service territory, a relatively large and growing number of customers have switched from ComEd's basic bundled service to delivery services, continuing a growth pattern that began as soon as the market opened to electric customers in October 1999. By the end of 2001, over 18,000 ComEd customers had switched either to alternative supplier or to the Power Purchase Option ("PPO"), a market-based service that is available only to the customers of the utilities that assess transition charges. Customer switching is nearing or has surpassed the 1,000 customer mark in the service territories of AmerenCIPS and Illinois Power, the two other utilities that charge transition fees and thus offer the PPO as an alternative to bundled service.

However, customer switching is still negligible or non-existent in the service territories of the state's smaller utilities. After two and one-half years of the availability of delivery services, there are few signs that customers in those service areas will have supply options other than the bundled service offering provided by the utilities when the restructuring law was enacted in late 1997.

Another trend evident in 2000 that continued into 2001 is the popularity of the PPO among both customers and suppliers. In the Commission's 2001 report, the

Commission found that approximately 40% of customers that switched to delivery services had switched to the PPO. During 2001, the reliance on the PPO continued to grow, as well over 50% of delivery services customers are now receiving electric service via the PPO. In the IP area, for example, the PPO is now unquestionably the dominant supply option. Approximately 99% of IP delivery services customers with a demand less than one MW and 75% of customers with a demand exceeding one MW have switched to the PPO.

The prevalence of the PPO as the main supply option is of concern to the Commission. Wholesale market prices dropped significantly between 2000 and 2001, which should have elicited a response from retail marketers to increase their wholesale power purchases to provide additional savings to customers. Instead of reselling wholesale power, however, many marketers continued to rely on the PPO as a supply source. Reliance on the PPO as a supply resource may be a future problem because the PPO will be dropped as a service offering when utilities cease charging transition charges.

The temporary nature of the PPO and its influence on the market was dramatically illustrated during 2001. Due to changes in the market value of energy, transition charges for many AmerenCIPS customers dropped to zero, which resulted in ineligibility for the PPO for those customers. The percentage of customers taking PPO service in the AmerenCIPS area then dropped from about 80% of all AmerenCIPS delivery services customers to less than 10%. Many of the former PPO customers subsequently returned to AmerenCIPS bundled service. Perhaps not coincidentally, delivery services growth in the AmerenCIPS area was very small compared to growth in the ComEd and Illinois Power areas.

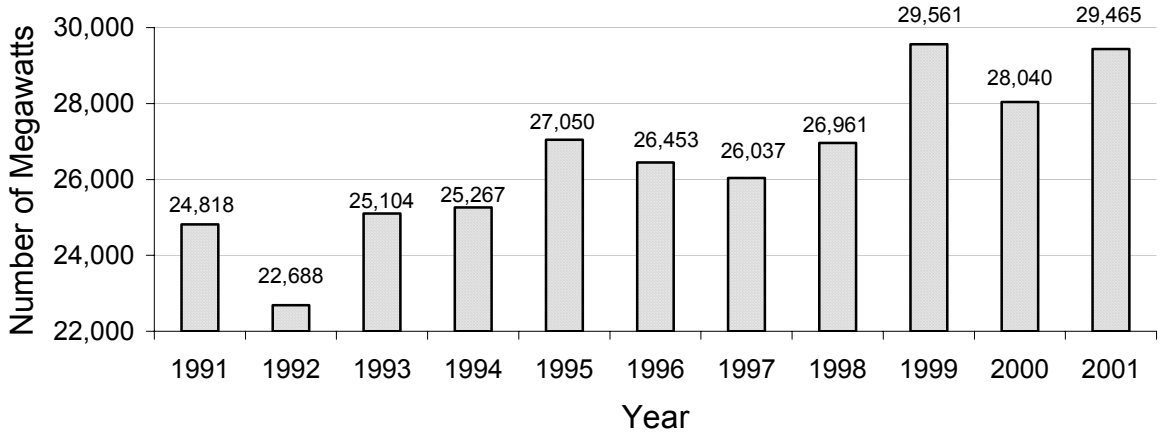
The Commission explained in its 2001 report that growth in the retail market is dependent on the competitiveness of the wholesale market. There are indications, however, that the wholesale market is not yet capable of supporting a competitive retail market. One sign of a lack of a vibrant wholesale market is that about half of the power supplied to delivery services customers is being sold to suppliers by the incumbent utilities through the PPO rather than by independent producers. There are few signs at present that this situation will change in the near future.

If the wholesale market remains relatively uncompetitive, prospects for a truly competitive retail market will not be fully realized. Just as important, an uncompetitive wholesale market will create upward pressure on the prices paid by customers who choose to remain bundled customers after 2005, when the present general rate freeze is terminated. The effect of an uncompetitive wholesale market on the prices paid by bundled customers is discussed in Section IV.

II. Peak Demand and Sales by Electric Utilities and ARES

Figure 1 shows the level of non-coincident peak demand of the State's nine investor-owned utilities between 1991 and 2001. Non-coincident peak demand in Illinois has grown at an annual rate of about 1.7% over the last decade.

Figure 1: Illinois Investor-owned Electric Utility Non-Coincident Peak Demand, 1991-2001 (MW)



A. Electric Sales By Electric Utilities and ARES

Sec. 16-120(b)(2) requires the Commission to collect data concerning the following:

> the total annual kilowatt-hours delivered and sold to retail customers in the State of Illinois by each electric utility within its service territory, each electric utility outside its service territory, and alternative retail electric suppliers in the preceding calendar year.

Sec. 16-120(b)(3) requires the Commission to express the information collected in response to Sec. 16-120(b)(2) in percentage terms. Together, these two subsections provide an indication of the success alternative suppliers have achieved in slicing into the utilities' dominant market share.

The Commission gathered information from the utilities and ARES concerning their electricity sales to retail customers. This information is summarized in Figure 2. Total sales by electric utilities include the following: (a) bundled electricity sales; (b) "contract sales," which include sales under Sec. 16-106 and Sec. 16-116 of the Act, sales under "special rate contracts" that were entered into prior to the December 1997 enactment of the 1997 restructuring law, sales to delivery services customers under the

incumbent utilities' delivery services tariffs and sales under "Interim Supply Service"[2]; (c) PPO sales, including both "unassigned" and "assigned" sales; and (d) sales by electric utilities outside their service territories. The sales by ARES are electric sales to delivery services customers under the incumbent utilities' delivery services tariffs. The sales by electric utilities plus sales by ARES equal "deliveries."

Figure 2 shows that, by the end of 2001, the ARES had made some inroads into the utilities' market position. All sales to retail customers, including delivery services customers, totaled approximately 130 million mWh during 2001; the ARES' shares of these sales were about 6.4 million mWh, or 4.9% of all sales. Sales by utilities inside their service territories were about 13.2 million mWh, while sales by utilities operating outside their service territories (AmerenCIPS, CILCO, Illinois Power and MidAmerican) were approximately 5.4 million mWh.

Electric utilities continue to be more successful than ARES in selling power and energy to customers eligible (or potentially eligible) for delivery services. Total ARES sales, consisting of direct sales to retail customers as well as sales under PPO - Assignment, were approximately 9.8 million mWh, compared to about the 13.2 million mWh that utilities sold under various types of contracts (competitive contracts and special contracts). It should be noted, however, ARES will likely acquire a greater share of sales as the utilities' contracts with bundled services customers expire.

Figure 2: Sales by Electric Utilities and ARES During 2001[3]

Sellers	*Electric Utilities*				*ARES*
Sales Category	*Bundled Sales*	*Contract Sales*	*PPO Sales*	*Outside Territory*	*Retail Sales*
Amount of Sales (Million mWh)	*94.1*	*13.2*	*10.7*	*5.4*	*6.4*
Percent of All Sales	*72.5*	*10.1*	*8.2*	*4.2*	*4.9*

III. Retail Market Competition

In this section the Commission examines various indicators of the development of a retail electric market in Illinois. Customer switching statistics are presented below in Figures 3-6 for the State's six largest utilities. Supplier activity is discussed in Section III.C.

[2] Interim Supply Service is a tariffed short-term service available to delivery services customers who have no source of electric supply.

[3] Electric utilities and ARES provided the data in Figure 2.

A. Delivery Services Growth

Customer switching rates, as measured by customer movement from bundled service to delivery services, continue to be high in the ComEd region relative to other service territories. As shown in Figure 3, over 18,000 ComEd customers have now switched to delivery services. Particularly notable is the fact that 50% of customers with demand of greater than one megawatt have made the decision to switch from bundled service to delivery services.

Figure 3 shows that only about 6% of smaller-use ComEd customers have switched to delivery services, a figure that seems greatly reduced from last year's 21% figure. However, with the introduction of delivery services to all non-residential customers, about 270,000 additional customers became eligible for delivery services, so the 6% figure is probably not indicative of the extent of delivery service activity in the ComEd area. A more relevant statistic is the amount of customer load that has switched to delivery services. These percentages (19% for smaller customers and 43% for larger customers) indicate that a significant amount of non-residential customer usage has switched to delivery services in the ComEd area.

Customer switching activity grew by only a modest 6% in the AmerenCIPS service territory, but by 33% in the Illinois Power territory, compared to 2000. However, only about 800-1,000 customers in these two service territories have switched to delivery services. The number of delivery services customers declined to zero (from 18) in the AmerenUE area. Likewise, in the MidAmerican Energy area, the number of delivery services customers dropped to near zero (from 186 in 2000 to 28 in 2001). No customer has switched to delivery services in the service areas of Central Illinois Light Company ("CILCO"), Interstate Power Company, Mt. Carmel Public Utility Company or South Beloit Water Gas & Electric.

Figure 3: Number of Delivery Services Customers in 2001

	Number of Customers Eligible for Delivery Services		*Number of Customers Switched to Delivery Services*		*Percentage of Customers Switched to Delivery Services (%)*	
Utility / Demand Level	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*
AmerenCIPS	52,229	1,300	719	51	1.4	3.9
AmerenUE	7,062	475	0	0	0.0	0.0
CILCO	30,733	174	0	0	0.3	0.0
ComEd	332,243	1,901	17,316	955	5.2	50.2
Illinois Power	65,561	219	812	41	1.2	18.7
MidAmerican	10,438	29	28	0	0.3	0.0
Total	498,266	4,098	18,875	1047	3.8	25.5

Figure 4: Amount of Usage Switched to Delivery Services in 2001

	Amount of Usage Eligible for Delivery Services (Thousand mWh)		*Amount of Usage Switched to Delivery Services (Thousand mWh)*		*Percentage of Usage Switched to Delivery Services (%)*	
Utility / Demand Level	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*
AmerenCIPS	1,389.6	4,597.9	73.4	150.3	5.3	3.3
AmerenUE	253.3	2,718.5	0.0	0.0	0.0	0.0
CILCO	1,512.8	1,007.9	0.0	0.0	0.0	0.0
ComEd	32,042.7	27,706.3	6,097.7	12,115.9	19.0	43.7
Illinois Power	4,632.7	8,617.8	533.6	3,857.4	11.5	44.8
MidAmerican	659.5	294.3	1.4	0.0	0.2	0.0
Total	40,490.6	44,942.7	6,706.1	16,123.6	16.6	35.9

B. Power Purchase Option

Figures 5 and 6 show that over 50% of ComEd's delivery services customers have switched to the PPO, a figure that has grown since last year, when less than 40% of ComEd delivery services customers were receiving PPO service. In the Illinois Power area, the PPO percentages are even larger. A remarkable 99% of Illinois Power delivery services customers under one MW are PPO customers, and about 75% of IP's larger-use delivery services customers have switched to the PPO. Only in the AmerenCIPS area did the PPO percentages decline from 2000. AmerenCIPS' PPO percentages dropped sharply as transition charges for most AmerenCIPS customers declined to zero, which resulted in ineligibility for the PPO for most AmerenCIPS non-residential customers during 2001.[4]

The Commission noted in the 2001 report that the popularity of PPO service can be viewed as an unfavorable sign of the prospects for the long-term development of a competitive retail market. From one viewpoint, the existence of the PPO allows customers to receive a rate discount even when no suppliers are serving the market. The PPO also allows suppliers to gain a market foothold and establish customer relationships because suppliers can essentially resell the utility's PPO to customers, either as a "billing agent" or through the "PPO Assignment" provisions of Section 16-110 of the Act. On the other hand, suppliers and customers can rely on PPO service only until the end of 2006. It is also possible that the PPO will vanish as a supply option prior to 2006 if a utility voluntarily forgoes the collection of transition charges or if customer transition charges equal zero, as they did for most of AmerenCIPS' non-residential customers during 2001. Once the PPO ceases to be a service offering, the customers who have found the PPO a convenient way to receive a rate discount without having to take a step into the market may well discover that they have to return to the

[4] Many AmerenCIPS' non-residential customers may become eligible for the PPO this year if their transition charges are greater than zero.

higher-priced bundled service, unless they are fortunate enough to find a RES who is willing and able to offer a competitive price. Moreover, there is no guarantee that bundled service will be available to all customers, as provisions in the Act permit utilities to petition the Commission to declare power and energy competitive, which could result in utilities dropping bundled service for some customers.

Figure 5: Selection of Power Purchase Option During 2001

	Number of Customers Switched to Delivery Services		*Number of Customers Selecting Power Purchase Option*		*Percentage of Delivery Services Customers on Power Purchase Option (%)*	
Utility / Demand Level	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*
AmerenCIPS	719	51	96	3	13.4	5.9
ComEd	17,316	955	9,683	563	55.9	59.0
Illinois Power	812	41	800	31	98.5	75.6
Total	18,847	1047	10,579	597	56.1	57.0

Figure 6: Amount of Usage Switched to the Power Purchase Option During 2001

	Amount of Usage Switched to Delivery Services (Thousand mWh)		*Amount of Usage Switched to Power Purchase Option (Thousand mWh)*		*Percentage of Delivery Services Usage on Power Purchase Option (%)*	
Utility / Demand Level	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*	*Less than 1 MW*	*Greater than 1 MW*
AmerenCIPS	73.4	150.3	11.6	33.3	15.8	22.2
ComEd	6,097.7	12,115.9	2,887.0	6,174.3	47.3	51.0
Illinois Power	533.6	3,857.4	527.2	1,236.3	98.8	32.1
Total	6,704.7	16,123.6	3,425.8	7,443.9	51.1	46.2

C. Retail Electric Supplier ("RES") Activity

Presently, a total of about 18 suppliers are qualified to sell power and energy to retail customers, a slight increase from 2000. The suppliers are comprised of the companies who received certificates from the ICC to sell power and energy to retail customers, as well as the electric utilities that sold electricity outside their service territories during 2000, collectively known as "RESs".

While 18 suppliers are entitled to sell power and energy, only nine suppliers were active in 2001 (that is, actually made electricity sales). With one exception, each of these suppliers is either an Illinois utility or an affiliate of an Illinois gas and/or electric utility. Other suppliers have participated in the market only by marketing the utility's PPO.

As was the case last year, most suppliers are concentrating their marketing efforts in the ComEd service territory only. As shown in Figure 7, seven suppliers sold power and energy (or took part in a PPO Assignment transaction) in the ComEd service territory during 2001, one fewer than in 2000. However, three suppliers have accumulated about 90% of all RES sales to ComEd customers. Three suppliers sold power and energy to downstate customers.

Figure 7: Number of Active Retail Electric Suppliers During 2000 and 2001, by Service Territory

Electric Utility Service Area	Number of Active RESs in 2000	Number of Active RESs in 2001
AmerenCIPS	3	2
AmerenUE	1	0
ComEd	8	7
Illinois Power	4	3
MidAmerican	1	1
All Others	0	0

D. Residential Market Activities in 2002

The Commission expects a slow start for the opening of the residential market in most areas of the State. One measure of the interest level among suppliers towards the residential market is the number of residential ARES applications. As of April 1, the Commission has not received any applications for certification to serve residential customers. However, as the Commission has received informal interest about certification requirements, including several suppliers not currently serving in the Illinois market, the Commission is hopeful that applications will be forthcoming in the near future.

Suppliers cite relatively high transactions costs as one reason why they may not direct their marketing efforts towards residential customers, at least in the near term. In particular, the cost of marketing to small-use, individual customers is high compared to the potential profit margin that a supplier might expect to receive by serving a residential customer. In the non-residential market, in contrast, suppliers were able to minimize their marketing costs by signing up customers belonging to large business groups. It remains to be seen whether suppliers will target groups of residential customers.

Another reason why the residential market may not be attractive to suppliers at the current time is that utilities do not offer the PPO to residential customers. Those suppliers that use the PPO as a primary supply resource will need to find other sources

of supply if they intend to serve residential customers. It is uncertain whether more than a limited number of residential suppliers will be willing to rely on the wholesale market for their supply, at least at the present.

Finally, the residential rate decreases required by the restructuring law, which now total 20% for ComEd and IP residential customers, have brought electric prices for the customers of these two utilities closer to the rates paid by customers elsewhere in Illinois and the Midwest. Suppliers may find it easier to interest customers in switching away from bundled service after the expiration of the rate freeze in 2005, when prices may rise from current levels.

The Commission expects that most residential supplier marketing activity will likely be centered in the ComEd service area. The customers taking part in the residential natural gas choice programs offered by Nicor Gas and the Peoples Gas Light and Coke Company may receive the first offers from suppliers. Since only a few marketers are presently active in the downstate areas, it would be surprising if marketers were to suddenly turn to the downstate customers now that residential customers are eligible for delivery services. Thus, the Commission does not expect suppliers to market to residential customers in the downstate areas until suppliers begin to market more heavily to the larger customers located in those areas.

IV. The Challenges Ahead: The Development of a Competitive Wholesale Market

The milestone of January 1, 2005 (the statutory end of the freeze for bundled electric rates) presents very significant challenges to the Commission. Foremost among these challenges is how to protect customers from the problems that a transitioning electricity market may offer in the short-run while simultaneously providing an environment where competition can be offered the opportunity to mature to the point where such protections are no longer warranted.

One of the legislative findings of Illinois' Electric Service Customer Choice and Rate Relief Law of 1997 is that "a competitive wholesale and retail market must benefit all Illinois citizens."[5] The Commission is charged with the responsibility "to promote the development of an effectively competitive electricity market that operates efficiently and is equitable to all consumers."[6]

To date, the restructuring law has provided significant consumer benefits through mandated reductions in residential bundled rates and a commercial and industrial customer rate freeze. In addition, some customers have been able to achieve

[5] 220 ILCS 5/16-101A (d)
[6] Ibid.

savings by switching to delivery services, obtaining their electric supply either from the PPO or from Retail Electric Suppliers. While these are tangible benefits of the restructuring law, the rate freeze and mandated rate reductions end on January 1, 2005. The energy component of bundled service rates, as well as the price of energy to delivery services customers, will then be determined by the potentially volatile electricity wholesale market.

The reasons for this change of circumstances are straightforward. Illinois utilities have already transferred or sold almost all of their generating units to unregulated affiliates or to unaffiliated companies. Utilities in Illinois now generate little or no power for their bundled retail customers or their unbundled delivery services customers. While utilities continue to buy power from their previously owned generating units, most of the power purchase agreements entered into between utilities and the new owners of their generation facilities will terminate at the same time as the rate freeze. The merchant generators have no regulatory or statutory obligation to supply power to Illinois consumers and will sell electricity to Illinois utilities only at wholesale market prices. Although the Commission retains authority over the structure and rates for bundled and delivery services, the Commission has no authority over the price of wholesale electricity sold to utilities for resale or over the electricity sold by RESs to retail customers via delivery service tariffs. Furthermore, utilities are not obligated to either invest in or hold generating assets. The ultimate cost of power and energy to both bundled and delivery services customers will be based on prices in the wholesale market.

The Illinois wholesale electricity market is likely to be dominated by the owners of generation purchased or transferred from Illinois utilities. While significant amounts of new generation have been constructed in Illinois since 1997, most of that generation is gas-fired peaker generation, with limited potential to compete against the base load plants formerly owned by Illinois utilities. The result of the concentration of generation ownership is the potential for the exercise of market power in the wholesale electric market in 2005 and subsequent years.

Another reason why the Commission is concerned about the ability of generators to exercise market power concerns the transmission system. The transmission system of today is a legacy from the previous regime of pervasive regulation of separate utility service territories and was designed not for sustaining competition across vast geographic areas but for helping basically self-sufficient utilities maintain reliability within their own service territories. With generation ownership concentration, and the absence of transmission development that would permit greater independent generator access to traditional Illinois utility service territories, the potential for a reasonably competitive wholesale electric market to develop in the near future is very limited.

Retail competition does not, in and of itself, prevent volatile and potentially inflated wholesale prices from being passed along to retail consumers from the wholesale market, competitive or not. Illinois retail customer dependence on the wholesale market for electricity is one of most significant changes created by the restructuring law, and underscores the importance of the development of competition in the wholesale electricity market. Without a competitive wholesale market for electricity, the potential benefits of retail competition will be lost or greatly reduced over time.

This is not to say that wholesale prices for electricity will always be above "average" levels in markets with highly concentrated generation ownership. The recent downward trend in wholesale prices has been a testament to the phenomenon that prices can rise and fall, depending on economic conditions. The current downturn in the economy has significantly reduced demand just as a significant number of new generators have been brought on line. As in any industry that is dependent on heavy capital investments, the business of wholesale generation will be subject to swings in the business cycle. An industry that requires heavy capital investment tends to have difficulty in balancing output capacity with demand. Capacity decisions tend to lag behind those in the market. This is due to the fact that large capital projects like generating facilities take time to build. During such times prices tend to soar, even in competitive markets. Once built, the typically high costs of exiting from such a market prevent a quick reduction in capacity. Again, supply has a lagged response and prices tend to fall dramatically during an economic downturn, even in heavily concentrated industries. The result is that supply will tend to be either too low or too high relative to market demand at any point in time.

This characteristic of the generation industry is one of the rationales behind the reservation requirements and the rationale behind the development and use of "Installed Capacity" ("I-CAP") markets that are being developed and used in restructured wholesale electricity markets like the PJM market. Load serving entities in these markets must contract for capacity, through the I-CAP market, for sufficient capacity to serve their forecasted annual peak demand. Reserve requirements prevent too little generation from being constructed so that reliability is not compromised during peak demand conditions, either weather- or economically created. The idea behind I-Cap markets is to ensure that enough generation exists at any one time so that prices for electricity never spike out of control during peak demand conditions, as they did during recent years in California. While such artificial measures can limit the size of the price spikes over time, they do not, and will not, prevent a concentrated market from enjoying higher than normal profits over time as a result of some measure of control over the wholesale price.

Due to limitations in its own jurisdiction and authority, the Commission must rely on the Federal Energy Regulatory Commission ("FERC") to ensure reasonable

prices in the wholesale electricity market and adequate provision of open access transmission service. The current federal policy, simply stated, is apparently to presume that competitive forces will self-regulate electricity prices and quality. How uncompetitive the regional electric markets will have to be for the FERC to resort to direct price regulation of electricity (either using traditional or performance-based approaches) is far from clear. It is also unclear how forcefully the FERC will act to guarantee that transmission capacity will be sufficient to support a competitive retail market for electricity.

The development of robust wholesale competition would clearly be the ideal solution to the potential problems ahead. However, there is no guarantee that robust wholesale competition will develop in Illinois by January 2005. Unreasonably high wholesale electricity prices, attributable to the market power of sellers, may prevail as long-term contracts expire. Under the right conditions, high wholesale prices can be self-correcting due to entry by new firms in wholesale and retail markets, the expansion of the transmission grid, and price-responsive demand. However, such corrections, even if feasible, may take significant time. Siting new generation and/or transmission takes significant time and effort, and is often opposed by the local populace. Effective demand-response programs are not often well received by participants and will take time to introduce. Complicating the process of self-correction are the incentives that utilities have to favor their affiliated and unregulated generation and marketing interests by creating economic and non-economic barriers to the entry of potential sources of competition. These incentives could lead incumbent utilities to favor their affiliates with regard to queues for interconnection transmission rights. In addition, these relationships provide little incentive for an incumbent utility to add new transmission capacity to its system. Any added transmission capacity, while allowing an affiliate access to more markets, would also allow a greater amount of competitive generation access to the affiliate's home market. Keeping the unregulated affiliate sheltered from competition may far outweigh its potential gains from trading outside its home market.

Given the California experience, and the market structure so far observed in Illinois, there is a concern that customers could be worse off under restructuring than under traditional regulation, at least in the immediate aftermath of the transition period. If, as in California, it is perceived that competition is not producing the promised benefits of lower prices and customer choice, there is the potential for restructuring to be permanently derailed, or at least hamstrung in its continued development before competitive benefits can be realized.

Significant challenges face the Commission. The first challenge is to encourage the rapid development of a competitive wholesale market for electricity in Illinois, given the problems created by highly concentrated generation markets and the current transmission system. The second challenge is the design of utility-provided bundled

energy services in the post-2004 period. Bundled service will need to provide customer shelter from potential volatility in the wholesale market, while providing the price signals and demand response necessary for competition to work in the long run.

V. Conclusion

The potential benefits to consumers derived from the freedom to choose within effectively competitive markets are well known to policymakers. Information presented in this report indicates that, in some service territories of the state, a fairly significant number of customers are taking advantage of the opportunity to reduce their electric costs. In particular, a large percentage of high-use customers are switching to either a lower-cost service generation service offered by the incumbent utilities or to services provided by Retail Electric Suppliers.

However, there are a number of problems facing the development of healthy competition for wholesale and retail electric power in Illinois as well as elsewhere in the United States. With respect to the retail market, even though wholesale electric prices are relatively low, over half of the customers who have switched to delivery services have switched to the Power Purchase Option rather than to a supplier who is purchasing power on the wholesale market for resale to retail customers. Supplier and non-residential customer reliance on the Power Purchase Option creates concern that few suppliers will be interested in marketing to the more than four million residential customers that will become eligible for delivery services in May 2002.

Problems in the wholesale market include affiliate ownership of generation, limited transmission capability and high market concentrations in generation ownership. Since most electric utilities will purchase from the wholesale market much of the power they need for their bundled customers in 2005 and beyond, problems in the wholesale market will create problems in the retail market as soon as 2005, when the existing rate freeze expires.

The Commission continues to investigate these wholesale market issues with the goal of providing policy options and suggestions. Any policies intended to promote competition in Illinois retail electric market must address the issues of market power abuse and price volatility in the wholesale market. Ways must be found to encourage improvements in the transmission and distribution capacity of the grid. The greater the capacity of the grid to move power, the greater the number and capacity of generators that can compete in a given market, and the greater the number of the generators that can be supported by the grid. Steps should also be taken to develop local sources of generation in the various service territories of Illinois. An increased number of local generators will increase price competition during peak-load hours when the physical limitations on the grid cut the load-pocket from outside competitors.

Barriers to the development of a competitive market for electricity in Illinois are numerous. The price that will be paid for ignoring these issues may be unreasonably high and/or volatile prices for electricity in 2005 and beyond, and the economic impacts of such energy costs on the Illinois economy. The solution to these issues will require that policymakers insure that market entry is possible, from both local and regional generation resources. This means policies, regulation, and tariffs that encourage new and independent generation, encourage upgrades to transmission and distribution systems, and that provide equal access to what transmission is available. It may also require the Commission to take a more active stance in identifying areas where transmission needs to be built in order to relieve constraints and reduce market power.

VI. APPENDIX: REPORTS ISSUED BY THE ILLINOIS COMMERCE COMMISSION, COMMISSIONERS AND COMMISSION STAFF ADDRESSING ELECTRIC RESTRUCTURING IN ILLINOIS

Title of Report	*Date Report Was Issued*	*Internet Address Where the Report is Located*
Reports on Experimental Programs		
Experimental Electric Programs (Section 16-106)	05/18/99	http://www.icc.state.il.us/icc/ec_doc_arch/012099.doc
Experimental Programs Initiated By Electric Utilities	06/23/00	http://www.icc.state.il.us/icc/ec/docs/000623expprogrpt.doc
Experimental Programs Initiated by Electric Utilities Under Section 16-106	11/07/01	http://www.icc.state.il.us/icc/ec/docs/011107gareport.doc
Distributed Resources		
Distributed Resources Deployment in IL, Comments & Reports - ICC Staff Report	01/12/00	http://www.icc.state.il.us/icc/ec/docs/000112disres.doc
Distributed Resources Deployment in IL, Comments & Reports - Report & Review of Comments	03/17/00	http://www.icc.state.il.us/icc/ec/docs/000317distrep.doc
Summary of Annual Utility Reports		
Summary of Electric Utility Annual Reports	05/18/99	http://www.icc.state.il.us/icc/ec_doc_arch/051899.doc
Summary of Annual Reports Filed by Electric Utilities Required by PUA § 16-130	08/24/00	http://www.icc.state.il.us/icc/ec/docs/000824GASummary.doc
Summary of Annual Reports Filed by Electric Utilities Required by PUA § 16-130	8/15/01	http://www.icc.state.il.us/icc/ec/docs/01081516130rpt.doc
Electric Reliability Report		
Electric Reliability - ICC Staff: Report to the Commission	02/28/00	http://www.icc.state.il.us/icc/ec/docs/000228relstaff.doc
Assessment of Electric Competition		
Assessment of Electric Competition - § 16-120	01/13/00	http://www.icc.state.il.us/icc/ec/docs/000112comprpt.doc
Assessment of Retail & Wholesale Market Competition In The Illinois Electric Industry	05/03/01	http://www.icc.state.il.us/icc/ec/docs/010503genrepcomp.doc
Staff Reports on the Neutral Fact Finder		
Staff Report to the Commission on Neutral Fact Finder	01/04/00	http://www.icc.state.il.us/icc/ec/docs/000120report.doc

Reports Issued by Chairman Mathias Addressing Electric Restructuring		
Restructuring the Electric Industry in Illinois	03/22/00	http://www.icc.state.il.us/icc/inside/cc/ops/001031cmoctround.doc
Roundtable Discussions re: Electric Service Customer Choice & Rate Relief Law of 1997	04/04/00	http://www.icc.state.il.us/icc/inside/cc/ops/000404cmroundtable.doc
Fall 2000 Roundtable Discussions re: Electric Service Customer Choice & Rate Relief Law of 1997	10/31/00	http://www.icc.state.il.us/icc/inside/cc/ops/001031cmoctround.doc
Can a California Energy Debacle Occur in Illinois?	02/01/01	http://www.icc.state.il.us/icc/inside/cc/ops/010207califenergy.pdf
Summer 2001 Electric Supply & New Generation	04/20/01	http://www.icc.state.il.us/icc/inside/cc/ops/010420cmhandout.doc
Fall 2001 Roundtable Discussions re: Implementation of Electric Service Customer Choice & Rate Relief Law of 1997	12/04/01	http://www.icc.state.il.us/icc/inside/cc/ops/011204cmrndtble.doc
Annual Reports Issued by the Illinois Commerce Commission		
Electricity, Gas, Water and Sewer Utilities Annual Report - 1997	1/31/98	http://www.icc.state.il.us/icc/Doclib/AR/013198_EGW.doc
Electricity, Gas, Water and Sewer Utilities Annual Report - 1998	1/31/99	http://www.icc.state.il.us/icc/Doclib/AR/030599_egwsanrpt.doc
Electricity, Gas, Water and Sewer Utilities Annual Report - 1999	1/31/00	http://www.icc.state.il.us/icc/Doclib/AR/000202elmain.doc
Electricity, Gas, Water and Sewer Utilities Annual Report - 2000	1/31/01	http://www.icc.state.il.us/icc/Doclib/AR/020301ec.doc